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# What has the invisible hand achieved?

Ross L. Watts\*

**Abstract**—This paper was commissioned for the Institute of Chartered Accountants in England and Wales Information for Better Capital Markets Conference held on 19-20 December 2005. It evaluates the effect of the market on financial reporting recognising that financial reporting and accounting are only parts of a general reporting, financing and governance equilibrium. That equilibrium is affected by the political process, as well as by capital and other markets. I explain how and why both market and political forces have influenced accounting and financial reporting and provide examples of those influences. Further, I draw implications for accounting standard-setting bodies that desire to change the nature of accounting and financial outcomes. Finally, I predict the effects of the radical standard-setting changes proposed by the FASB and IASB.

## 1. Introduction

When I was invited to present at this conference I was asked to address the question: 'What has the invisible hand achieved? (in financial reporting)'. This is a rather broad question and an impossible one to answer using the evidence in the empirical accounting literature in capital markets alone. Accounting is only one mechanism in financial reporting and corporate governance and it evolved to fit in with other mechanisms, to be part of a general reporting, financing and governance equilibrium. The evidence in the international accounting literature is consistent with such an equilibrium (e.g., Ball et al., 2000). Evaluating the market's effect on financial reporting requires an understanding of the market's effects on financing and corporate governance, an understanding of the extent to which mechanisms in those areas substitute for, or complement, accounting and financial reporting. Thus, evidence on the evolution of corporate finance and governance is crucial to any assessment of the market's achievements in financial reporting.

Another factor that is crucial in the assessment of the market is the legal and political environment. Markets require property rights in order to function. The nature of those property rights affects financial reporting. For example, the effective limited liability of joint stock companies appears to have influenced debt contracts and the accounting in those contracts and in shareholder reports (see Watts, 2003). When the political process produces changes in property rights, the

market adjusts. When shareholders' rights to bring litigation were changed in the US in the second half of the twentieth century the market responded by making accounting and financial reporting more conservative despite the antipathy of the Financial Accounting Standard Board (FASB) towards conservatism in financial reporting (see Basu, 1997; Holthausen and Watts, 2001). The nature of financial reporting and accounting that evolves in the market is influenced by the political process and as a result the market demand for financial reporting also influences the political process (see for example Watts and Zimmerman, 1978; Ramanna, 2005).

The consequence is that the market achievements are a function of economic forces that determine both the private economic arrangements and the outcomes of the political process. If proposed changes in accounting standards and financial reporting ignore those economic forces and generate unverifiable accounting numbers and the market is unable to prevent those changes occurring and/or adjust for them, the market will tend to ignore the resultant financial statements and disclosures and find other ways to meet the demand for financial reporting.<sup>1</sup>

Understanding the market's achievements requires an understanding of the market's responses to the demand for accounting and financial reporting that is generated both from the market and from the political process. My objectives in this paper are to:

- i) explain the how the market has responded in the past to demands in the market itself and to demands that come through the political process;

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<sup>1</sup> Evidence of the market ignoring unverifiable accounting numbers can be found in Leftwich (1983), who reports that debt contracts exclude goodwill when measuring total assets.

- ii) derive implications for standard-setting bodies and others who want to change the nature of accounting and financial reporting; and
- iii) predict the effects of current proposed standards.

To those ends the next section explains how and why private market forces have influenced accounting and financial reporting. Section 3 explains how and why the political process and the courts have affected accounting reporting. In Section 4, I provide implications for how accounting reporting standards should be set. Section 5 predicts the eventual outcomes if the FASB and International Accounting Standards Board (IASB) continue in their apparent resolve to fundamentally change the nature of accounting and financial reporting. Finally, Section 6 provides a summary and my conclusions.

## 2. Private market forces and financial reporting

### 2.1. Agency costs and financial reporting

The original development of accounting and financial reporting appears to be driven by control of agency costs. These costs arise when a principal delegates decision-making ability to an agent who maximises his own welfare rather than that of the principal. There is considerable evidence that writing itself was developed in order to allow for accounting and control of the costs of agency relations such as that between a noble and a steward (de Ste Croix, 1956; Yamey, 1962; Chadwick, 1992). Millennia later, the wardens of English medieval guilds would prepare and present audited financial accounts as a mechanism to reduce agency costs (Watts and Zimmerman, 1983). The early English companies inherited this mechanism from the guilds. For example, even in its first years the British East India Company prepared annual audited financial statements and presented those statements to its shareholders (Watts and Zimmerman, 1983). Effectively, audited financial reporting was a corporate governance mechanism.

### 2.2. Accounting conservatism

The audited financial statements also played a role in the early English company's contracts. In Watts (2003) I argue that the use of those financial reports in debt contracts influenced the nature of accounting, providing an incentive for conservatism: a higher standard of verifiability for recognition of gains than for losses. This asymmetric recognition of gains and losses generated an understatement of net assets. Effectively it produced a lower bound estimate for net assets that could be used to restrict divi-

dend payments and reduce the agency costs of debt. Such restrictions appeared around the time faceless share trading started in the London stock market.<sup>2</sup> Faceless share trading effectively generated limited liability, which in turn made borrowing very difficult.<sup>3</sup> Dividend covenants in debt contracts made it less likely that funds could be inappropriately distributed to shareholders. Anticipation of losses and lack of anticipation of gains meant that net assets were likely to be a 'hard' number. That accounting is similar to corporate liquidators' accounting when making timely distributions to claimholders in a way that does not violate legal priorities.

Individuals also have limited liability in the sense that there is a limit to the penalties that can be imposed on them. That limited liability combined with the manager's limited tenure and horizon (e.g., retirement) likely plays a role in accounting's conservatism (Watts, 2003). The manager has an incentive to recognise gains and defer losses until after he has left the firm to avoid being fired and to earn higher earnings-based compensation. Once paid, such compensation is difficult to recover. Conservatism defers recognition of the gains until there is verifiable evidence that the gains exist, or in other words until there is 'hard' evidence (see below).

The empirical evidence is consistent with the limited liability of the shareholders (managers) inducing asymmetric loss functions for the debtholders (shareholders) in contracting with shareholders (managers) (Watts, 2003). These asymmetric loss functions caused efficient debt and compensation contracts and corporate governance mechanisms to use conservative accounting that deferred recognition of gains. That deferral reduced the amount of inappropriate early distributions to both shareholders and managers.

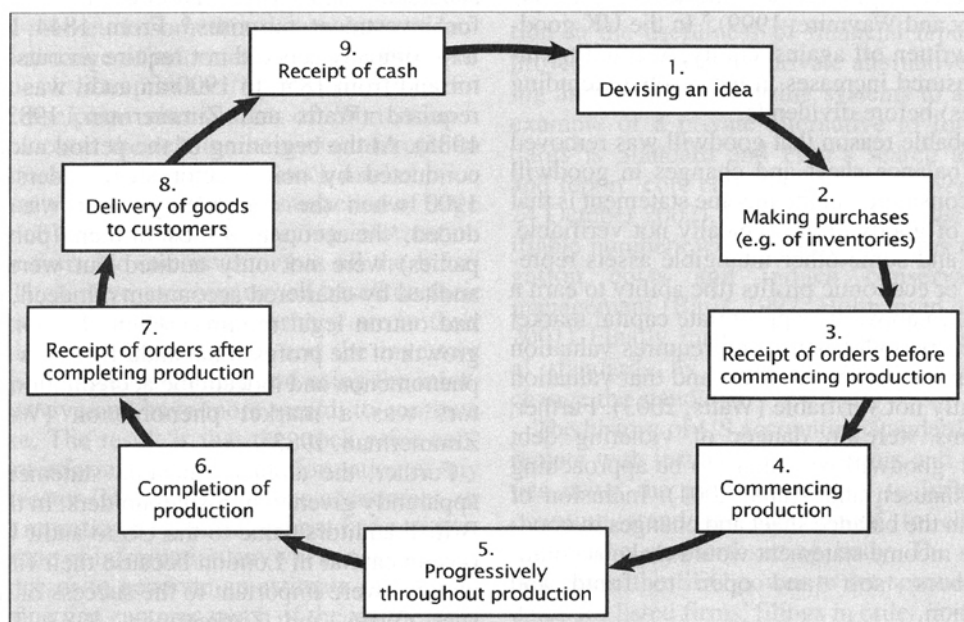
### 2.3. Timely reporting

The evidence also suggests that while conservatism is part of the efficient private contracting and governance accounting procedures, it does not alone determine the recognition of gains. Timeliness of reporting is also important. Before formal standard-setting there was variation in the timeliness of recognition of gains across indus-

<sup>2</sup> Kehl (1941:4) reports that in 1620 the corporate charter of the New River Company included a provision that dividends could be paid from corporate profits only. He also states that those provisions were employed in the rest of the seventeenth century and became increasingly more common in the eighteenth century. This time series suggests that the inclusion of the dividend provision in charters was voluntary.

<sup>3</sup> DuBois (1938:95) concludes that *de facto* limited liability existed by the 1730s and 1740s and that 'for England at any rate, the fact of incorporation either by the Crown or by Parliament came to be the criterion for the extent of limited liability' (p. 96).

**Figure 1**  
**The operating cycle**



Source: AARF, ED 51B

tries, presumably induced by 'common law' type principles enforced by auditors.<sup>4</sup>

Figure 1 reproduces a graph of the operating cycle produced by the Australian Accounting Research Foundation. The different boxes in the graph can be considered as potential points for the recognition of profit. The most timely recognition would be at point 1 when the entrepreneur first has the idea for a positive net present value project. This is the point that Jeff Skilling (President/COO and briefly, CEO of Enron) argued should be used for recognising profits and at which Enron did recognise 'profits' in many cases (McLean and Elkind, 2003). The problem with point one is that the expected cash flows for the profits are in the future, very uncertain and not verifiable. Recognition at that point is likely to generate frauds (as in Enron's case).

As one moves around the cycle, the outcome becomes less uncertain. Historically, accounting waited for the profits to become verifiable. By the beginning of the twentieth century most firms recognised profit at the time title to goods passed, at the time of delivery (point 8). However, in some industries firms were able to recognise profit at an earlier point in the operating cycle, in particular at points 5 and 6. Two prominent examples of such industries are mining and construction. Until the Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 101 (SEC, 1999),

some mining firms listed on US exchanges still recognised profit at production (Demers et al., 2005). Why were firms in these industries able to recognise profits earlier than other firms? The apparent answer is that the mining firms had contracts for the forward sale of their output. The output's sale and its sale price were guaranteed by contract, so recognition of profit at production would not induce overproduction by management to overstate profits (create frauds). In construction, some firms had contracts that gave them guaranteed payments at various stages of the construction process. This evidence suggests that when the nature of the sales contracts made fraud less likely and profits verifiable, efficient private accounting allowed profits to be more timely. Profits were reported as soon as they were verifiable.

#### *2.4. The nature of the balance sheet and income statement*

The emphasis in private contracting is on distribution of net assets so the balance sheet is a conservative estimate of the value of the net assets rather than a measure of firm value (i.e., the balance sheet did not incorporate the value of rents). Intangibles such as goodwill are excluded from the calculation of net assets in debt contracts

<sup>4</sup> See Matheson (1893) for a discussion of the auditors' fights with managers over accounting procedures.

(Leftwich, 1983). Consistent with this contracting, before the Securities Acts in the US, goodwill was typically written off the balance sheet as soon as possible, often being reduced immediately to one dollar (Ely and Waymire, 1999).<sup>5</sup> In the UK goodwill was written off against equity. Accounting income measured increases in net assets (excluding intangibles) before dividends.

The probable reason that goodwill was removed from the balance sheet and changes in goodwill were not considered in the income statement is that estimates of goodwill are typically not verifiable. Goodwill and some other intangible assets represent rents or economic profits (the ability to earn a rate of return above the appropriate capital market rate). Their periodic estimation requires valuation of the firm (or part of the firm) and that valuation is frequently not verifiable (Watts, 2003). Further, when firms were in danger of violating debt covenants, goodwill was likely to be approaching zero (Holthausen and Watts, 2001). Inclusion of goodwill in the balance sheet and changes in goodwill in the income statement would make accounting numbers 'soft' and open to fraud and manipulation.

It is important to note that even though market-driven accounting was conservative prior to the establishment of the US Securities and Exchange Commission (SEC) in 1934, tangible asset values were occasionally written up to their market value when the increased asset value was verifiable. Fabricant (1936) reports that in a sample of 208 large listed industrial US firms in the period 1925–1934 there were 70 write-ups of property, plant and equipment and 43 write-ups of investments. The investment write-ups were likely securities traded in liquid markets where the market value could be observed. Revaluation of property was associated with financing (Finney, 1935, ch. 40). If an independent appraiser had valued the property for refinancing purposes, the appraised value was likely to be verifiable (particularly if the appraiser was employed by the lender). Just as in the operating cycle, market accounting allowed greater timeliness when there was verifiability. The SEC effectively banned asset write-ups in the late 1930's (Zeff, 1972:156–160; Walker, 1992).

### *2.5. The role of financial reporting in providing information to the market*

As indicated above, the early English companies did present audited financial statements to the shareholders at the annual general meeting. The

tremendous growth of the London stock market in the second half of the nineteenth century caused substantial changes in the auditing of financial statements and the provision of financial reports for investment purposes.<sup>6</sup> From 1844–1900 the UK company acts did not require an outside auditor and from 1856 to 1900 an audit was not even required (Watts and Zimmerman, 1983; Hunt, 1935). At the beginning of the period audits were conducted by non-director shareholders, but by 1900 when the compulsory audit was reintroduced, 'the accounts of most of them (public companies) were not only audited but were in fact audited by chartered accountants. Indeed, practice had outrun legal minima' (Hunt, 1935:454). The growth of the professional audit firm was a market phenomenon and indeed, the accreditation of auditors was a market phenomenon (Watts and Zimmerman, 1983).

Further, the audited financial statements were apparently given to non-shareholders. In the 1890s British auditors came to the US to audit US firms raising capital in London because their firms' reputations were important to the success of those issues (Watts and Zimmerman, 1983; DeMond, 1951). Stock exchange requirements played a role in the presentation of audited financial statements in the US (see Benston, 1969). Such requirements were introduced not because of governmental regulation but because the exchanges found it to be in their own self interest. Different US exchanges had different requirements allowing variation in the quality of information presented.

Despite the use of audited financial statements for evaluation of investments, prior to the US Securities Acts the accounting produced by listed companies for the purpose of raising capital was essentially the same accounting produced for contracting and control purposes. Daines (1929:94) describes the dominant objective of accounting as being 'to reflect that income which is legally available for dividends'. Further, even though the Securities Acts were based on a broader information role for financial reports, US practice and opinion among accountants was slow to change in that direction. Forty years after the Securities Acts, a 1975 FASB survey found that only 37% of respondents agreed with the information role being the basic objective of financial statements. Those disagreeing took the position that 'the basic function of financial statements was to report on management's stewardship of corporate assets and that the informational needs of readers was of secondary importance' (Armstrong, 1977:77).

Why didn't accounting take on the broader role suggested by today's standard-setters and provide a broader range of information and even estimates of the market value of the firm (as implicit in FASB proposals)? Why did the general opinion of

<sup>5</sup> State company law dividend restrictions caused the management of some companies not to write-off goodwill because the write-off would prevent them paying dividends.

<sup>6</sup> Between 1853 and 1893 the nominal value of listed securities on the London stock exchange increased by a factor of 14 (Morgan and Thomas, 1962).

accountants in the US disagree with that broader view, 40 years after the Securities Acts? My answer is that the evidence suggests accounting's comparative advantage in supplying information to capital markets is something other than producing a broad range of information or an estimate of firm value. It is to produce 'hard' verifiable numbers that discipline other sources of information.<sup>7</sup>

Let us look at the relation between information and the stock market price. The stock market price for a security is the result of the interaction of large numbers of investors all with varying information about the firm. No one investor has all the information. Those investors buy or sell based on their information. The more confident they are in their information the more they bet and the investors who are successful in gaining and using the information survive and have more wealth to continue to operate. The result is that the stock price contains more information than the information of any single investor (Hayek, 1945). The accountant, or financial reporting in general, cannot hope to produce a range of information anywhere near what is in the price or to generate an estimate of a firm's equity value that captures much of the information that is in the market price. Despite some anomalous evidence, the great bulk of the evidence in finance supports this conclusion.

How then does accounting fit into the supply of information to capital markets? The outcomes of events implied by information eventually flow through the company's cash flows. Accounting does not wait for all the cash flows to occur. For example, in Figure 1 profit is recognised (at sale or production) before cash inflows occur. Accounting is more timely than cash flows (e.g., Dechow, 1994), but accounting information in financial statements is still generally verifiable or 'hard'. Most recent frauds are not due to soft standards, but are the result of a failure to apply existing standards.

If an analyst reports an expected increase in a company's profitability, the quality of the analyst's information can be checked by observing whether the company's accounting income later reflects that predicted increase. Market participants come to learn which analysts are better predictors and better sources of information than other analysts and consequently stock prices react more to those analysts' information. If accounting standard-setters force accountants to include unverifiable value changes in income, income will become noisy and frauds will increase. This will reduce the ability of the market to identify the most reliable analysts and indeed the most reliable other sources of information. If accounting financial statements become 'soft' so will the information generated by other sources.

## 2.6. Market reactions to soft accounting and financial reporting

Soft accounting standards generated by standard setters will generate market reactions. Any reduction in the usefulness of financial reporting will provide incentives for private alternative accounting and financial reporting systems to appear. An example of a private alternative to formal standards is Standard and Poor's search to identify and report 'core earnings' (*Business Week Online*, 24 October 2002). Increasing frauds due to unverifiable numbers will generate increases in US litigation costs and induce conservatism by management (Basu, 1997; Holthausen and Watts, 2001). Finally, managers will react to dysfunctional standards by using the political process to change the standards.

The history of US accounting standard-setting is replete with instances of managers and other parties using the political process to influence accounting standards and indeed to change the accounting standard-setting body. The Securities Acts gave the SEC power to set accounting standards for listed firms' filings in order (among other things) to reduce the variety of accounting procedures. Over the years since, the SEC has delegated the setting of standards first to the Committee on Accounting Procedures (CAP) (1939–1959), then the Accounting Principles Board (APB) (1960–1973) and finally the FASB (1973–?). The inability of the CAP to reduce the diversity of accounting procedures, ill-will from management from the attempted elimination of procedures and consequent pressure from Congress was the cause of the CAP's demise in 1959 (Moonitz, 1974). The APB alienated corporate management, politicians and the financial community with its proposals on business combinations (pooling) and other issues and consequent Congressional pressure caused it to be replaced by the FASB (Zeff and Dharan, 1994:2–3). The FASB's survival and the consistency of US standards with IASB standards depends heavily on the political process. Standard-setters cannot depart significantly from the market equilibrium without their standards being supplanted by private alternatives or themselves being replaced by an alternative mechanism via the political process. Finally, the courts' interpretations of the accounting that results from the standards play a major role in how standards work in practice.

## 3. Political forces and financial reporting

For convenience, I include the legal system, the political system and regulation in the conduits for political forces affecting accounting and financial reporting.

<sup>7</sup> Lambert (1996) and Ball (2001) also suggest accounting plays a role in disciplining other sources of information.

### 3.1. Legal system

There is evidence that US courts significantly increased the conservatism reflected in listed firms' published financial statements. Informal and formal evidence (Holthausen and Watts, 2001) suggests US financial statements were conservative before the Securities Acts as expected from the contracting and corporate governance forces acting in the market. However, there was relatively little litigation under those acts until the rules for bringing class action suits were changed in 1966 (see Kellogg, 1984; Kothari et al., 1988). The rules change enabled lawyers to act as entrepreneurs in bringing lawsuits and increased litigation significantly. The legal market responded to the change in rules and caused a large increase in the conservatism of the financial reports – a market response by corporate managers.

At one level, the explanation for why increased litigation produced more conservatism in the US is relatively simple as Beaver (1993) and Watts (1993) pointed out. The reason is that in securities suits, buyer suits outnumber seller suits by 13 to one (Kellogg, 1984). If a firm overstates its income and net assets, a suit is much more likely than if the firm understates its income and net assets. Basu (1997) uses periods of changing liability identified in Kothari et al. (1988) to test and confirm the Beaver and Watts prediction. Holthausen and Watts (2001) confirm the Basu results on a longer period. On the basis of the US litigation effect, Ball et al. (2000) predict that financial statements of UK listed companies are less conservative than the statements of US listed companies. They find results consistent with that prediction.

At a deeper level, the explanation for litigation's effect on conservatism could be related to the conservatism generated by market accounting. US courts' asymmetric treatment of realised losses (buyers' suits) and foregone profits (seller's suits) mirrors a similar asymmetry found in regulation by the Federal Drug Administration (FDA) that might also reflect court behaviour (Peltzman, 1976). The FDA acts as though realised deaths or realised side effects of drugs released are more important than lives lost because drugs are not released. Perhaps it is more difficult to produce verifiable evidence of profits that might have been made and lives that might have been saved than to produce verifiable evidence of losses that actually occur and the cause of deaths that actually occur. Whether it is that explanation or whether there is an asymmetric loss function in the public sector as well as in the private sector, accounting financial statements generate asymmetric costs for gains and losses. Given the size of litigation in the US, accounting financial statements and disclosures (Hutton et al., 2003) are likely to continue to be

conservative regardless of the standards introduced by the FASB.

### 3.2. The political process and regulation

The political process has significant influence on accounting standards at least in the US (Watts, 1977; Watts and Zimmerman, 1978; Ramanna, 2005) and likely in the UK as well. Congressional concern with standards played a role in the replacement of the APB by the FASB. Recent FASB examples of Congressional involvement include: SFAS 115 (accounting for securities investments, FASB, 1993); SFAS 123 (expensing employee stock options, FASB, 1995); SFAS 133 (accounting for derivatives and hedges, FASB, 1998); SFAS 141 (elimination of pooling, 2001a) and SFAS 142 (impairment of goodwill, FASB, 2001b).

In the last case (SFAS 141 & 142) opponents of the elimination of pooling had a bill introduced into Congress to override the FASB. With that bill in Congress, opponents went to the FASB with a compromise that would eliminate the amortisation of goodwill and replace it with impairment. The FASB adopted the compromise even though the compromise in effect made firms that pooled 'better off' in terms of their objectives: the opponents kept the stronger income that pooling produces by eliminating amortisation; and they gained the stronger balance sheet that purchase generates. The stronger balance sheet can be achieved because the valuations for determining goodwill impairment are unverifiable so that impairment can be avoided (Watts, 2000; Ramanna, 2005). The impairment is assessed at the reporting unit level where there is typically no observable equity market value. Ramanna (2005) is able to predict the positions of firms lobbying on the standards using those firms' ability to manipulate the estimated values necessary for impairment.

History makes it apparent that standard-setting in the US is constrained by political forces – if the standard is too far from a political equilibrium, it cannot last. The long-term political equilibrium in the US appears to require conservatism, so it is likely that SFAS 142 will not last in its current form. Some of the firms with unverifiable goodwill that are underperforming will fail and in the political process part of the blame for failure will be attached to the failure of the accounting methods to recognise that assets were overstated.

Watts (1977:67) argues that conservatism is the equilibrium in the political process because losses from overstatement of asset values and income are more observable and usable in the political process than foregone gains from understatement of assets and income. This in turn could be due to differences in ability to verify or differences in loss functions (see above), but regardless of reason,



conservatism's effects are apparent. The rationale for the Securities Acts was that the NYSE crash in 1929 was due to overstatement of assets and income (Benston, 1969). This rationale caused the SEC to ban upward revaluations of assets for 30 years (Zeff, 1972:156–160; Walker, 1992). And, there is other evidence that the SEC is still more conservative than the market: the revenue recognition standards in SAB 101 are more conservative than market forces would dictate. Vogt (2001) points out that in some cases SAB 101 requires less timely recognition than implied by contract law. Certainly, SAB 101 did stop some mining companies from recognising profit at production in circumstances the market had allowed for at least a century (see above).

The Vogt (2001) paper is an example of the limits the market places on standard-setters and regulators. The paper is aimed at contracting professionals and provides examples of how to write contracts to avoid the over-conservative consequences of SAB 101, for example how to contract to ensure revenue is recognised at sale with no deferral. At the other end of the spectrum we observe the finance community working hard to allow their clients to avoid constraints on capitalising leases so as to keep debt off the balance sheet and generating new securities to produce 'instant' profits (see below).

The bottom line is that in the US, the behaviour of the courts, Congress and regulatory bodies such as the SEC and Public Company Accounting Oversight Board (PCAOB) will ensure that US accounting standards will be conservative. This will constrain the FASB's ability to introduce and sustain accounting standards that involve unverifiable asset and income increases. Given that we observe conservatism generated privately by contracting and other market forces in the UK, I would expect similar but perhaps weaker restrictions on standard-setting there as well.

#### 4. Implications for accounting standard-setting and financial reporting reforms

The cumulative evidence on the economic forces acting on accounting via the market and political processes provides strong cautions for those proposing to reform or significantly change accounting and financial reporting. If those proponents want their reforms or changes to work and last, they must ensure those reforms or changes:

- anticipate how managers and others will react to any standards or proposed reforms;
- require verifiable numbers for financial statements;
- do not try to value the firm;
- allow conservatism; and

- have a conceptual framework that is flexible enough to accommodate equilibrium accounting methods resulting from the economic and political forces

##### 4.1. Anticipate reactions to standards

If standard-setters or reformers want their standards or reforms to be introduced and to last, they have to look ahead to how various individuals will react to the standards or reforms, particularly managers. A good standard or reform is one that works in practice and how it works in practice will depend on how managers and others use it.

In Watts (2003) I report an example of a standard-setting body's failure to anticipate managers' reactions and their consequences. As a market maker in energy-related contracts and derivatives, Enron management marked those instruments to market (trading securities) and reflected the value changes in earnings used in bonus compensation (McGraw-Hill Inc., 2002). The FASB's Emerging Issues Task Force (EITF) allowed managers of firms making markets in thinly traded energy-related contracts and derivatives the discretion to choose the 'bid' price or the 'ask' price for valuing those instruments at the end of a period. As a market maker (in some cases the only market maker) Enron could determine those prices (Weil, 2001). Weil reports that Enron's ask prices often were as much as eight times their bid prices. Given such high ask prices would not lead to sales, they produced significantly overstated values and earnings. It is difficult to imagine how any experienced auditors on the EITF could not anticipate such an obvious result.

##### 4.2. Require verifiability

At present the FASB is proposing to revise SFAS 141 to allow profits to be recognised on 'bargain purchases' (FASB, 2005a). These are acquisitions where the fair value of the net assets of the firm acquired exceed the acquisition price. Since the fair value of the net assets is determined by the management of the acquiring company this seems to allow unverifiable 'instant' profits on acquisitions. Management of more than a few companies are certain to take advantage of this opportunity to overstate and inject noise into their earnings, making accounting and financial reporting 'softer'.

In their current state, SFAS 141 and 142 introduce unverifiable estimates into accounting (Watts, 2003). They require the recognition of different types of intangible assets that in total represent rents. Given that rents are essentially the return to monopoly power, they do not represent individual assets (unless they are separable and saleable in the form of a licence or a taxi medalion). Any attempt to allocate rents to individual intangible assets is equivalent to allocating joint



benefits: no meaningful allocation is possible. Any one allocation of rents is as good as another, so the required allocation provides managers with opportunities to introduce both noise and bias into earnings. Earnings become 'softer'.

The impossibility of meaningful rent allocation appears to be used by managers to avoid goodwill impairment under SFAS 142. That standard requires acquired goodwill to be allocated across reporting units. If there are synergies between the reporting units, there is no meaningful way to make those allocations. This provides managers with the opportunity to locate purchased goodwill in reporting units that already have large *unrecognised* rents or goodwill (they have grown their own goodwill). Since impairment is assessed at the reporting unit level, that unrecognised goodwill will mask any overpayment and consequent goodwill overstatement and significantly reduce the likelihood of future impairment.

In addition, the SFAS 142 requirement that, in order to estimate goodwill impairment, managers estimate the value of reporting the unit using discounted forecasted future cash flows, forecasted earnings and earnings multiples, or other similar methods also considerably increases the 'softness' of earnings. Anyone who has tried to value a growth firm knows how difficult it is to forecast future cash and how large a range of values are possible. With the market value of the reporting unit unobservable, the management's valuations of those units are certainly not verifiable. The consequence is that despite the fact that many firms recognised goodwill impairment in SFAS 142's transitional year (for big bath and below-the-line reporting reasons) hundreds of firm with a market-to-book ratio less than one did not report impairments (Beatty and Weber, 2005). SFAS 142 introduced considerable variation in earnings across firms, variation that is due to lack of consistent treatment of goodwill impairment. Earnings became 'softer' and noisier.

#### 4.3. Do not try to value the firm

Earlier in this paper I made the argument that the market value of a listed firm is likely to incorporate more information and be a harder estimate of value than a manager's unverifiable estimate. Holthausen and Watts (2001) make the same argument. Why should accounting and financial re-

porting compete with the market in this dimension? Concentrating on such estimation to the detriment of providing hard data that help market participants estimate market value seems perverse. It is likely to reduce information in the marketplace both by making accounting numbers less meaningful and removing accounting's disciplinary role from the market. At a minimum, traditional transaction-based financial statements should be retained as one set of information provided.

#### 4.4. Allow conservatism

In the US, any attempt to ban accounting conservatism is sure to fail. Pressures from the courts and from the regulatory and political process will induce many managers and accountants to make financial statements conservative nevertheless. At the same time, a lack of conservatism will allow some managers to generate frauds. The consequent political reaction to such frauds will eventually generate removal of the responsible standards and likely eventual removal of the responsible standard-setting body.

The usual reason for opposing conservatism is that the information provided in financial statements should be unbiased and as noise free as practicable. If unbiased and low noise information *in practice* is the objective then the response of some managers to an unverifiable standard should be anticipated and built into the design of the standard. The EITF and FASB examples given above provide strong support for this prescription.

#### 4.5. An accommodating conceptual framework

The US Securities Acts were built on a myth: that accounting and financial reporting caused the 1929 NYSE crash and the great depression.<sup>8</sup> That story provided a convenient rationale for the Securities Acts and the appearance that Congress was doing something to remove the causes of those calamities. The rationale also created a demand for a conceptual framework to guide the regulation of accounting and financial reporting (Watts and Zimmerman, 1979). The SEC (aware of the substantial variation in existing accounting and reporting and the economic and political costs generated by standardisation) passed that role onto a sequence of private standard-setting bodies. The normative conceptual frameworks that emerged to provide guidance and rationales for choice of accounting and reporting procedures do not take account of the market and political processes that determine the nature of accounting and financial reporting. And, it is not apparent that completely open and frank consideration of those forces would be politically viable. However, consideration of the forces in determining the framework is essential to prevent the proliferation of standards that stand no chance of achieving their objectives.

<sup>8</sup> The evidence on the nature of asset revaluations (Fabricant, 1936; Finney, 1935) suggests they were not fraudulent. Further, economists consider the cause of the depression to be trade wars (Kindleberger, 1986) and poor monetary policy (Friedman and Schartz, 1963). By the end of 1929 the Dow Jones Index had recovered to record a loss for 1929 of only 17% and stock prices continued rising in early 1930. In 1930 President Hoover signed the Smoot-Hawley tariff, raising tariffs on dutiable items by 52%.

## 5. Likely outcome of proposed changes in reporting

I foresee a number of likely outcomes of the currently proposed changes in financial reporting, given the economic and political forces that determine accounting practice:

### 5.1. International accounting standards

It is difficult to envisage a true standardisation of international accounting standards. First, the US Congress is unlikely to cede that right to an international body. Their demonstrated willingness to intercede in the standard-setting process is not likely to disappear. Lobbying by various groups will continue. International accounting standards have no government to enforce them. Second, the frauds likely to emerge from accounting standards that do not consider manager reactions, the importance of verifiability and conservatism will certainly reinforce Congress's strong incentives to intervene. Third, having only one set of standards limits the evolution of accounting that works. When large numbers of companies can experiment and invent new methods of accounting, one of those experiments might actually improve financial reporting and lead to other firms imitating the new accounting method. The number of such experiments has been reduced enormously by the existence of national standard-setting bodies. Reduction of the number of standard-setting bodies that experiment similarly reduces the likelihood of efficient innovation.

### 5.2. Future of the FASB

The current FASB seems committed to a course that is likely to be disastrous for the institution. It will either be replaced by a governmental agency or significantly restructured. The reasons for this prediction are spread through my preceding discussion. Two likely focal points are:

*Ability to audit standards.* At the last American Accounting Association meeting a former board member (with no denial from the board members present) publicly declared that it was not the FASB's responsibility to consider the ability to audit their standards when setting standards. The FASB's sister institution, the Public Company Accounting Oversight Board (PCAOB), that, like the FASB, is responsible to the SEC is concerned about the ability to audit recent standards such as SFAS 142. When the SEC has to examine specific examples of the problems that non-auditable standards generate (frauds), it is highly likely to take the PCAOB's side. Evidence of such a reaction is provided by the SEC's relatively recent SAB 101 that adopts a more conservative revenue recognition standard than market forces generate (see Watts, 2003). Like all regulatory bodies, the SEC has strong incentives to be conservative.

*Move to firm valuation.* After centuries of transaction-based financial statements and reporting, the FASB proposes financial reporting to move to a firm valuation approach. Inclusion of intangibles that are intended to capture rents, changes the balance sheet from measurement of the opportunity cost of investment and the abandonment option to measurement of firm value. Schipper (2005) argues that in estimating firm value the FASB imitates the market. The imitation comes from the use of discounted cash flows, earnings multiples, etc. However, the strength of market valuation is not the varying forms that market participants use to value firms, but the large numbers of participants with varying information that cause the market to incorporate a wide spectrum of information in the market price. The FASB mistakes the form of market valuation for its substance. In the past the FASB has acted as though an important function of accounting is to inform market participants, a function consistent with the evidence. This FASB is undertaking an experiment based on the form of the market process not its substance. Reliance on form means the experiment is likely to fail. Unless the SEC or other regulatory bodies intervene promptly, the experiment will generate significant numbers of market frauds.

Correction seems unlikely to occur immediately. The FASB is still writing standards that are intended to include fair value (including valuation of the firm) into what is effectively its conceptual framework. On 21 October 2005 the FASB issued a working draft of SFAS 15X (fair value measurements, FASB 2005b) that the FASB intends to be effective for financial statements beginning after 15 December 2006. On 25 January 2006, the FASB issued an exposure draft of a proposed statement of financial accounting standards (FASB 2006) that suggests firms be given the option to value certain financial assets and liabilities at fair value, beyond the requirements of SFAS 115. That draft states that it is phase 1 of a fair value project. Phase 2 would extend the option to non-financial assets and liabilities and to some financial assets and liabilities excluded from phase 1.

### 5.3 Market use of financial reporting

Debt contracts have increasingly contracted out of a number of GAAP standards (see Watts, 1977; Leftwich, 1983; Beatty and Weber, 2005). If the FASB and IASB continue on their current course, debt contracts may cease to use GAAP-based accounting entirely. Similarly, compensation contracts currently use many performance measures other than earnings. I expect the relative use of modified GAAP earnings in top management compensation to decline if standard-setters continue on their current course.

The declining use of accounting numbers from

the audited financial reports in their traditional contracting role is likely to affect the financial reports of private companies. It is entirely plausible that if GAAP-based reports do not meet the contracting market test, alternative accounting reports that are audited by non-CAs or CPAs could replace them. Recent CPA ethics cases suggest this is already happening.

If GAAP-based published audited financial statements also fail the market test in providing information for share valuation (as seems likely if they are designed to value equity and produce unverifiable numbers), individuals who currently use those statements will increasingly turn to other, more reliable, alternatives.

## 6. Conclusion

The survival of GAAP-based financial reporting requires that reporting meet economic and political demands. Injudicious changes in reporting that do not consider economic and political forces will not survive or if they do, that reporting will be a mere formality and not be used for productive purposes. In this latter event, other mechanisms will arise to meet the demands ignored by formal reporting. The result could well be that CPAs or CAs will find themselves replaced by competitive institutions.

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